August 6, 2012

BEFORE THE FEDERAL MARITIME COMMISSION

Response to Notice of Inquiry – FMC Export Indexes (Docket No. 12-07)

I am writing in response to the Commission's Notice of Inquiry (Docket No. 12-07) soliciting comments on a proposal by unnamed parties that the FMC produce and publish freight rate indexes for certain US agricultural export commodities using service contract data confidentially filed with the agency.

As explained in greater detail below, I believe that adopting the subject proposal would be both inappropriate and unwise. I am further concerned that the proposal, which would involve assigning scarce FMC resources to a non-regulatory function for which the agency appears to lack statutory authority and in-depth expertise, seems likely to mainly benefit a limited number of financial derivative marketers and corporate agri-businesses. Furthermore, the subject proposal might prove harmful to American agricultural exporters -- and, possibly, to the Commission itself. American taxpayers, who the originators of the proposal presumably expect to foot the bill, would not be well served.

Looking at some of the concerns raised and discussed at the Commission's May 16, 2012 meeting, shows why the export indexes proposal is so problematic. Those concerns include the question of the Commission's statutory authority, the possible competitive impacts of the proposal, and the absence of evidence demonstrating a need for FMC-produced contract rate indexes.

Statutory Authority

At the Commission's May 16, 2012 meeting, the issue of whether the FMC has statutory authority to create and publish the proposed freight rate indexes was raised by Commissioners Dye and Khouri. They expressed strong doubts about the Commission's legal authority to publish service contract-based rate indexes. Commissioner Khouri even queried the FMC's General Counsel on the matter.

In her response, the General Counsel opined that the Commission had "a statutory mandate to support US exporters." Later in the meeting, Chairman Lidinsky echoed that view -- stating that: "The Shipping Act tells us [the FMC] to promote the growth and development of US exports." Those responses, even if taken at face value, do not address the question of *how* the Commission might be authorized to pursue such a goal.

Chairman Lidinsky apparently was referring to section 2 of the Shipping Act which presents the four "purposes" of the Act. The fourth purpose, added as part of the Ocean Shipping Reform Act of 1998's (OSRA) changes, refers to promoting "the growth and development of United States exports through competitive and efficient ocean transportation *by placing greater reliance on the marketplace.*" [Emphasis added.]

At the May 16th meeting, Commissioners Dye and Khouri attempted to give the fourth purpose some context by referencing OSRA's objectives in reforming the Shipping Act: greater reliance on market rate setting via confidential contracts as opposed to the Act's previous statutory requirements for rate transparency via published contract and tariff rates. The focus of the newly added fourth purpose, when viewed in the context of the OSRA changes it accompanied, is on ensuring that one-to-one, confidential negotiations determine rates.

As Commissioner Dye remarked: "If a commercial product regarding freight indices is desirable, the marketplace -- private investors -- will develop and support it." And that already seems to be the case. In his introductory remarks at the May meeting, Dr. Pearson, the director of the Commission's Office of Economics and Competition Analysis, observed that in the post-recession environment, "the number of ocean rate indices now available to the shipping public has proliferated." That proliferation was market driven and likely will continue without FMC intervention.

The issue here is not the potential value that various rate indexes might (or might not) offer US exporters or others, nor the possible pluses or minuses of derivatives which indexes might support. The issue is the limited authority Congress has vested in the

Commission under the Shipping Act (and perhaps the Commission's status as an *independent* federal agency).

It seems a remarkable stretch, and a complete disregard for the Shipping Act's legislative history and any credible "whole text" reading of the Act, to identify the fourth purpose's "greater reliance on the marketplace" with the establishment, by a federal regulatory agency, of a non-regulatory program to produce freight rate indexes. All the more so when one realizes that the *first* purpose of the Act calls for the Commission to act with "a minimum of government intervention and regulatory costs."

The application of traditional cannons of statutory interpretation, such as that (1) a statute must be construed as a whole, and (2) interpretation cannot add anything to what the text actually states or reasonably implies, should effectively eliminate the subject proposal. The Act's fourth "purpose" must be read in the context of the Shipping Act as a whole, which strictly concerns liner shipping *regulation*. The absence of any suggested non-regulatory role for the FMC -- including as a producer of commercial indexes -- should settle the question. Eisegesis of the sort implied by the informal "interpretation" of the Act's fourth purpose offered at the May meeting is simply not credible.

Why the FMC?

The apparent rationale underlying the proposal's argument for FMC action is, perhaps, too simple -- namely that because service contracts are filed with and reviewed by the FMC, the FMC should be the agency to create and publish indexes using data from those contracts. The logic is unpersuasive.

Even if, for the sake of argument, one accepted that confidentially filed rate data may and should be used to produce freight rate indexes for commercial use, there are other federal agencies that are far better equipped than the Commission – by reason of staff size, greater in-depth expertise and organizational mission – to structure and manage such indexes. One thinks, for instance, of USDA which has a strong and well-staffed economic research division and experienced export marketing assistance programs that, as part of USDA's promotional mission, could -- through a memorandum of understanding (MOU) with the Commission -- access the service contract rate data needed to create the proposed rate indexes.[1]

Agency Resources

In developing, updating and maintaining the proposed indexes, the Commission would presumably draw on the resources of the Commission's Office of Service Contracts and Tariffs and its Office of Economics and Competition Analysis. Given the Commission's staff limitations, that presumably would leave fewer resources available for analyzing new carrier agreements, monitoring existing agreements, assisting agency investigations and conducting useful economic and industry research. The question of resource allocation would increase in prominence if and when the indexes were expanded beyond the initial four.[2]

Service Contract Data Vulnerability

The subject proposal appears to assume that service contract filing with the Commission will exist in perpetuity. That, however, may be an unwarranted assumption. Liner companies bear the burden of filing service contracts, and (very frequently) amending them, and are not fans of the existing filing requirement. Twice in the last six years, the National Industrial Transportation League (NITL), a major shippers' association, has publicly criticized the Shipping Act's contract filing requirement as unnecessary.[3] Furthermore, the Commission's recent decision to exempt non-vessel-

[1] The post-Fact Finding 26 creation of USDA's new weekly container equipment report provides a recent example of how USDA can provide marketing services to US exporters that initially were identified as useful by the FMC. Furthermore, the NOI text notes that USDA's Agricultural Marketing Service has expressed interest in having access to the contract rate data. Perhaps a memorandum of understanding could achieve that without requiring the FMC to act outside its statutory authority. Does such an MOU perhaps already exist?

[2] The question of how many indexes the Commission would ultimately produce – and the standards for determining which commodities would qualify for FMC indexes – is an interesting and important one.

[3] In comments provided on behalf of NITL on October 18, 2006 to the Antitrust Modernization Commission, and on June 19, 2008 before the Committee on

operating common carriers (NVOCCs) from publishing rate tariffs, instead allowing them to maintain written records of the outcomes of rate agreements with their customers, raises the question of whether similar provisions might not be adequate for vessel operating carriers, too.

The notion that because the service contract filing process is now well established it will prove permanent is questionable. Industry speculation about possible future legislative changes to the Shipping Act often includes the elimination of service contract filing as one likely reform. Should the Commission (or even USDA) adopt the subject proposal and publish freight rate indexes using confidentially filed data, carrier and shipper organizations might find common cause in opposing such a program through Shipping Act reform. If the agency's primary stakeholders were to conclude that the intent of the compromises that made OSRA possible was being ignored or abused by the Commission, they could take their case to Capitol Hill.

There is also the fact that service contracts are filed in the Commission's SERVCON system. A review of the system's track record over the past few years, and how SERVCON problems (if there have been any) might impact frequent review and publication of sample contract rates, is a technical issue the Commission also might want to consider.

Whose Proposal?

At the May 16th Commission meeting, Commissioner Khouri closed his comments with an expression of concern:

"I have serious problems with the proposition that large ag [shippers], OTIs and Wall Street derivative brokers [are] coming into our offices asking us to use the confidential data in our possession, and at the same time asking us to keep their identities

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Transportation and Infrastructure's Maritime and Coast Guard Subcommittee, the League declared it highly questionable whether the practice of filing service contracts continued to make sense from a cost/benefit viewpoint. And that was before the Commission's changes to NVOCC tariff rate publishing requirements.

confidential. Where is the transparency here? I believe this is bad public policy, and I believe it is bad agency policy."

Later in the meeting, Chairman Lidinsky responded:

"And as to Commissioner Khouri's point about people revealing their identity, in a Notice of Inquiry they can't hide. They've got to sign their statement, and I think we'll look very closely at that."

The rather odd implication of the response seems to be that transparency doesn't matter with respect to who crafted and lobbied for this unorthodox and controversial proposal. But transparency is indeed important ("we'll look at it closely") when comments are provided. Really? Why not look closely (and publicly) at both?

Still, it is not difficult to guess some of the likely sponsors of the proposal. When one Googles the phrase "ocean freight rate derivatives" the names Morgan Stanley and Clarkson Securities appear prominently in the results. If one goes further and looks at the on-line announcement for the forum held by the Container Freight Derivatives Association on June 18, 2012, Clarkson Securities and Morgan Stanley are front and center again. They are joined by GFI Group Inc., HSH Nordbank (risk management – hedges) and the NVOCC TSC Container Freight. And while I do not know who the original sponsors of the subject proposal are, I would be surprised if the some of the above organizations were not among them

As to the issue of looking closely at who files comments, when agriculture giants like, for instance, ADM comment on the proposal (assuming ADM chooses to do so), one wonders if the views expressed will come from (and be identified as coming from) ADM's food and feed divisions or from ADM Investor Securities International (brokerage services for international markets). Again, I don't know if ADM, Cargill or any other corporate agri-giants were among the sponsors of this proposal – the point is that agri-giants' commercial interests go well beyond grain shipment freight rates.

The concerns Commissioner Khouri's expressed at the May meeting are, I believe, well founded. It is not too late for the FMC to lift the veil of secrecy and make public the identities of the proposal's originators. Or, if they continue to insist on secrecy, the FMC could suspend further action until they are willing to stand in Justice Brandeis's famously disinfecting sunlight. In a situation like this, the duty of publicity clearly outweighs any alleged claim of privacy – and the Commission should insist on it.

Why Create Indexes?

The unnamed originators of the proposal assert that FMC-created indexes (for hay, frozen meat, cotton and grains initially, but perhaps other commodities in the future) will help reduce rate volatility. In particular, they appear to claim that carriers are "reluctant to" (presumably suggesting they often *will not*) sign contracts for periods beyond 30 to 60 days.[4] This is a claim that FMC staff should be able to evaluate -- and should have been asked to evaluate prior to a decision to seek an NOI. If they were, the results were not apparent in the NOI text or the May 16th discussion of the proposal.

At the May meeting, Commissioner Khouri raised the question directly:

"How much truth is there in the assertion that ocean carriers will not give valid, and I guess that means fixed, contract rates for more than 60 days?"

Gary Kardian, director of the Commission's Office of Service Contracts and Tariffs, replied that in looking at the rates of the four selected commodities "[w]e do see the fact that there are periods of time that the rate will hold steady for let's say a year, maybe longer. We also see that rates in various times where rates changed every 30 days, every 60 days. It's between the shipper and the carrier. A lot of times it's because of the MQC [minimum quantity committed] probably being low. We don't know that for a reason...We're just collecting data."

[4] NOI, pages 4 and 5.

Mr. Kardian's reply would seem to indicate that the truth of the assertion had not yet been evaluated. His supposition that low MQCs could account for limited durations for contract rates, however, suggests that rate duration may be largely the shippers' choice. Minimum quantity committed is determined by the shipper.

It would seem that before establishing a staff task force and initiating an NOI process, the Commission might have considered asking some basic questions about the alleged "carrier reluctance." For example:

> Are the unnamed parties who crafted the proposal able to give specific, concrete examples of instances of the alleged carrier "reluctance" and its impact on export sales that Commission staff could evaluate? [It's not clear they were asked to do so.]
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> How many informal complaints and/or requests for CADRS assistance has the Commission received from agricultural exporters about carriers not allowing longer contract rate periods?
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> During the Commission's in-depth Fact Finding 26 investigation into shipping problems in 2010 (including contracting and rate setting practices), did exporters of agricultural commodities raise issues about carriers being unwilling to offer annual or longer rates?
>
> Of the four commodities being considered (hay, frozen meat, grain and cotton), are any seasonal? Likely to shift between container and bulk shipping service based on rates? Do shippers of the commodities typically seek less than one-year contracts? Have production and supply chain issues that make longer-term forecasting (and rate commitment) impractical?

Perhaps such questions were raised earlier. If so, neither the background material in the NOI nor the discussion at the May meeting makes that clear. And that can be a serious problem because dramatic assertions, unsupported by evidence, are too often offered as fact. For example, Morgan Stanley's comments in response to this NOI assert that:

"The inability of shipping lines to provide truly fixed forward rates to shippers more than 30-60 days out at best, dramatically impacts the competitiveness of U.S.

exporters delivering to distant locations where freight costs are a significant portion of delivered commodity prices." (Page 3)

Morgan Stanley's claim is rhetorically strong, but fails to offer any evidence or any concrete examples that could be checked. Indeed, when one compares Morgan Stanley's rhetoric about the "inability of shipping lines to provide truly fixed forward rates to shippers more than 30-60 days out at best" with Mr. Kardian's observations at the May meeting about the FMC's freight rate research -- "[w]e do see the fact that there are periods of time that the rate will hold steady for let's say a year, maybe longer" -- the rhetoric rings a bit hollow.

Morgan Stanley offers the same unsubstantiated claim that the NOI attributes to "some [but unnamed] U.S. agriculture exporters." (Pages 4 and 5) Such unsupported general claims about an alleged need for FMC-produced export indexes is another reason to be clear about who the sponsors of and lobbyists for this proposal are. And also a powerful reason for the Commission to undertake certain basic analyses before issuing NOIs.

The World Shipping Council (WSC), in its response to this NOI, pointed out that:

"It would be economically illogical for a carrier to be unwilling to 'increase the certainty of an exporter's transportation costs' and 'lock in a rate that would be valid for more than 30 to 60 days' if the rate will yield a sufficient financial return to the carrier." (Page 4)

Given the competition that presumably exists in the eastbound trans-Pacific trade, both from independent lines and within Westbound Transpacific Stabilization Agreement's membership, WSC's point about economic logic seems fairly persuasive. Additional analysis of the "economic logic" of the carrier reluctance allegation, by the Commission's economists, might be useful.

Market Failure or Bureaucratic Overreach?

The non-disclosure of the sponsors' identity and the apparent absence of factual evidence supporting a need for government intervention (even leaving aside the statutory authority issue) raise questions: Is this proposal a response to a true market failure to which the government (if not necessarily the FMC) could bring greater efficiency? Or is it a case of a special interest group identifying an FMC-based confidential information source that it could profitably exploit, and convincing the Commission that taking on a new function would be mutually beneficial?

The Commission's apparent lack of critical curiosity about the proposal's rationale before issuing the NOI could (accurately or not) be seen as implying that the agency believes that the subject proposal has identified and can improve on a clear instance of market failure. The absence the sponsors' identity -- and the lack of a thorough preliminary assessment of the their claims -- makes it difficult to determine whether the proposal involves creating a public benefit that the market would not be able to produce, or is an example of bureaucratic overreach in response to special interest lobbying.

Who Benefits

At the May 16th Commission meeting, Dr. Pearson, director the agency's Office of Economics and Competition Analysis, mentioned that the agency staff still had a number of important decisions ahead:

"[W]e've got a lot of technical economic, competitive and legal issues to navigate through. Kind of look at this exercise as if you can imagine taking a trip from one side of Bangladesh to another. There are lots of bridges to cross, and we still need to cross them."

Dr. Pearson mentioned, as two such bridges, future decisions on whether to use simple averages or weighted averages in producing the rate indexes, and how frequently to publish those rates. Regarding the latter, he said:

Dr. Pearson: "But it depends on [to] what use [the index] is being put. For short-term use, for instance in financial instruments, it would need to be current."

Commissioner Khouri: "Derivatives?"

Dr. Pearson: "And frequent. Yes."

In his closing remarks, Chairman Lidinsky mentioned that those lobbying for FMC indexes told the Commission: "FMC, if you want to help us, here's how you can help. The data you're sitting on in your computers, we need it, we sample it, *put out a weekly index*. [Emphasis added.] As Dr. Pearson's comments may indirectly suggest, a requirement for weekly rate indexes might suggest that the subject proposal has as much or more to do with the financially profitable creation of marketable derivatives than with reducing rate volatility.

The Bridges of Bangladesh

To return to Dr. Pearson's Bangladesh analogy for a moment: One usually doesn't spend a great deal of time making travel plans for crossing a country that one has no visa to visit. Congress, however, has not issued the FMC a passport to tour (much less colonize) policy regions outside its regulatory borders. So one might expect a clear and definitive presentation of the Commission's statutory authority to precede the sort of detailed technical economic analyses to which Dr. Pearson refers. And since the proposal involves a new and non-regulatory undertaking not addressed in the Shipping Act, one might expect the Commission to have raised the indexes proposal with its oversight committee before issuing an NOI. If it did so, there is no indication in the NOI text or the May 16th meeting of what the outcome of such discussions might have been.

One of Dr. Pearson's other bridges-to-be-crossed is a competitive impact analysis of the proposal's likely impacts. Such a competition analysis, it would seem, makes most sense prior to issuing an NOI. If such an analysis was completed, the Commission's May 16th meeting gave no indication of what its findings were.

Indeed, based on the questions and responses at the FMC's May meeting, it would appear that a full competitive impact analysis had *not* yet been conducted. In particular, the likelihood that the commodity indexes under discussion (if properly produced) would make the ocean transportation costs of American exporters publicly available to their international competitors didn't seem yet to have been addressed. That is especially odd given the importance that the issue of rate transparency played in OSRA's rationale for introducing confidential contracts in place of publicly available rates. [5]

All in all, one could have come away from the FMC's May 16th meeting with the impression that the Commission had not fully addressed either the agency's statutory authority, or the proposal's likely competitive impact, or the validity of key allegations meant to support the proposal (i.e., "carrier reluctance") prior to issuing the NOI.

Conclusion

In evaluating responses to this NOI, the Commission will, at a minimum, need to address three simple questions:

1. Does the Commission have statutory authority under the Shipping Act to use confidential service contract data to produce commercial freight rate indexes?

   Neither the language of the Shipping Act nor its legislative history suggests Congress intended any such non-regulatory authority. Quite the contrary.

[5] Certain comments in Clarkson Securities' response to the NOI regarding the purpose of the proposed indexes providing "greater price transparency that drives market efficiencies" seem not to take account of the *asymmetric information* problem that transparent US transportation costs might create vis-à-vis foreign competitors. And the comment that "the ability to charge arbitrary premiums to some customers is the main reason that liner executives are resistant to initiatives that promote [rate] transparency," may come as a surprise to the shipper organizations like NIT League that fought against the lines' preference for *publicly available* tariff and contract rates (that is, rate transparency) to make confidentially negotiated service contracts the backbone of OSRA.

2. If such indexes are to be produced, is the FMC the federal agency best suited to perform the task?

Probably not. Such a determination does not follow from the fact that the FMC is the agency where contracts are filed and reviewed.

3. If a majority of the Commission believes that the agency has a legitimate non-regulatory role in producing rate indexes for commercial purposes, and the requisite expertise and resources to do so, should it first seek explicit Congressional authority to so radically expand its mission?

That would seem prudent.

I believe that adopting the subject proposal would be inappropriate and unwise. Inappropriate because it requires the creation of a non-regulatory program for which the FMC lacks legislative authority; because it might impede the agency's ability to effectively carry out its legislatively mandated functions; and because other federal agencies (USDA for example) are better equipped to do the job.

Unwise (even if USDA undertook the job) because there could well be a net negative impact on American exporters vis-à-vis their international competitors; because FMC stakeholders might respond by seeking an end to the service contract filing requirement; and because adopting the proposal might give the appearance of promoting a non-regulatory agenda for personal or partisan reasons.

For the above reasons, I respectfully encourage the Commission to stick to its statutory mandate and decline to adopt the subject proposal. Alternatively, the Commission could suspend further action on the proposal until the its originators agree to publicly attach their names to it, and, in the meantime, conduct a thorough review of the likely competitive impact of the proposal and the Commission's statutory authority to adopt it.

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Disclaimer: These comments are solely my own views. They do not represent the position of my employer.